VZCZCXRO7107
RR RUEHRG
DE RUEHSO #0486/01 2611718
ZNR UUUUU ZZH
R 171718Z SEP 08
FM AMCONSUL SAO PAULO
TO RUEHC/SECSTATE WASHDC 8520
INFO RUEHBR/AMEMBASSY BRASILIA 9652
RUEHRG/AMCONSUL RECIFE 4193
RUEHRI/AMCONSUL RIO DE JANEIRO 8849
RUEHBU/AMEMBASSY BUENOS AIRES 3248
RUEHAC/AMEMBASSY ASUNCION 3495
RUEHMN/AMEMBASSY MONTEVIDEO 2773
RUEHSG/AMEMBASSY SANTIAGO 2495
RUEHLP/AMEMBASSY LA PAZ 3908

UNCLAS SECTION 01 OF 03 SAO PAULO 000486

SIPDIS
SENSITIVE

STATE PASS USTR FOR KDUCKWORTH
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

C O R R E C T E D C O P Y (CORRECTING FORMATTING ISSUES)

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: GLOBAL FINANCIAL VOLATILITY-BRAZIL RESERVED NOT SCARED

REF: SAO PAULO 476

SAO PAULO 00000486 001.2 OF 003

¶1. (SBU) Summary: The unprecedented bankruptcy of Lehman Brothers, the fourth largest U.S. investment bank, sent shockwaves across the financial markets, hitting Brazil's stock exchange, the Bovespa, particularly hard. On September 15, the Bovespa fell 7.59 percent, bringing the total losses for the year to 23 percent as of September ¶16. While these kinds of market movements are quantitatively significant, they do not seem to reflect any sense of local panic, but rather a readjustment of asset prices and international investors cashing in to improve liquidity in the United States and other markets. Most commentary here, in fact, seems remarkably calm and detached. Analysts may be slightly surprised by the scale of the market movements on September 15, but are in no way hysterical. The biggest near-term risk for Brazil is the possible decline in foreign direct investment, which has been financing Brazil's current account deficit. A global decline in demand could also slow Brazil's exports and negatively impact the trade balance; however, economic interlocutors downplayed either occurrence, citing Brazil's domestic economic performance and the Brazilian Central Bank's prudent monetary policy as anchors for economic stability. End Summary.

Brazil Did its Homework

¶2. (SBU) Across the board, economic interlocutors told Econoff that this week's turbulence was more about global risk aversion than any indication of a decline in Brazil's economic fundamentals. Mauricio Oreng from Itau Bank told Econoff that global investors were fleeing from assets with even the smallest risk, noting that some preferred holding cash. As a result, he said that emerging market stock exchanges and commodities prices had naturally suffered the consequences. In particular, Brazil's stock exchange, the Bovespa, dropped 7.59 percent on September 15, in part because nearly 60 percent of its value is directly tied to commodities. Giovanna Rocca from Unibanco told Econoff that because Brazil implemented prudent fiscal and monetary policies, the economy is doing well. She cited the Brazilian Central Bank's (BCB) efforts to curb inflation and the accumulation of foreign reserves of over USD 200 billion as sufficient to face immediate liabilities. Indeed, Priscila Trigo from Bradesco asserted that the BCB's hawkish approach to curbing inflation and cooling domestic growth stands

apart as an example for other emerging market countries to emulate.

¶3. (SBU) The strength of the Brazilian banking sector was also noted when defending Brazil's position amid the global financial turbulence. Oreng told Econoff that Brazilian banks continue to be extremely well-capitalized according to Basel standards. External funding represents a small fraction of funding, and delinquency rates are very low, and although the Central Bank raised interest rates, bank performance is not linked to the interest rate. Similarly, Rocca told Econoff that Bradesco has counseled investors to sit tight because they view Brazilian financial institutions as solid.

Potential Concerns Minimal

¶4. (SBU) Over the medium-term, Brazil's trade balance could decline given the deteriorating outlook for commodity prices and the fact that Brazil is still forecast to grow at a fairly robust pace. In fact, the most recent GDP forecast, unemployment data, and new incoming FDI announcements have surprised on the upside. Looking further down the road, Trigo told Econoff that the biggest risk facing Brazil is that foreign direct investment inflows would decline, noting that FDI and portfolio flows are funding Brazil's current account deficit (Reftel). She posited that if commodity prices continued to fall, exports would decline and further undermine Brazil's trade balance; however, imports would also decline if the Brazilian currency continued to depreciate relative to the US dollar. (Note: The Real has depreciated 20% from its high of 1.56/USD on August 1 to 1.86/USD on September 17. End Note.) She concluded that she did not believe that FDI would dry up in Brazil, but could slow down due to the lack of liquidity worldwide. Alexandre Cancherini from Merrill Lynch supported this view explaining that Brazil's relatively low domestic savings rate requires Brazil to depend on financing from abroad. Although he does not expect any banks to collapse, he believes that small banks would feel the higher borrowing costs because of the global

liquidity crunch and that some could face bankruptcy over the longer-term.

¶5. (SBU) The current turmoil in financial markets was also the primary topic of conversation at a dinner the Consul General hosted for 10 American company CEOs on September 16. Citibank Brazil President Gustavo Marin stated the crisis is far from over, and argued that the effects will percolate through the financial sector for some time to come. He correctly predicted that the USG would step in to prevent the precipitous collapse of American insurance giant AIG. Marin believes that European and Asian banks have yet to realize the full extent of their losses, and that once the financial sector upheaval has abated, restricted credit will begin to play through the performance of major economies, reducing growth rates. Marin predicted that the major impacts of the crisis on the Brazilian economy would be through tighter credit conditions for major development and investment projects (public and private) - reducing the level of new investment activity - and reduced IPO activity in Brazil. He also expects to see a significant uptick in Merger and Acquisition (M&A) activity due to reduced book values for many companies, both in Brazil and abroad. He noted that recent Brazil IPOs are currently trading at 40 to 50 percent of earnings, making them attractive M&A targets. Brazil growth should slow to three to three and a half percent in 2009, but rebound to five percent level in 2010.

¶6. (SBU) Nelson Barbosa, Secretary for Economic Policy at the Ministry of Finance told Brasilia Econoff that he thought that Brazil would fare well, even given the drop in commodity prices because Brazil still imports more petroleum than it exports. He said he didn't foresee the need for Brazil to take any specific measures in response to recent problems. He said he thought that the problems in the U.S. financial markets were contained and that the situation would right itself soon, probably after the November elections when the uncertainty over the next administration would be eliminated.

Uncertainty to Continue

¶7. (SBU) Economic interlocutors all pointed to widespread uncertainty about the future economic performance of the U.S. and the broader global economy. Trigo noted that decisions in the U.S. including whether the Federal Reserve would need to rescue another bank, the duration of a U.S. slowdown, and possible contagion effects have spooked the market. These uncertainties would limit available financing and could restrict investment, she said, both of which could damage Brazil. Rocca told Econoff that Unibanco expects the BCB to take a wait-and-see attitude and is expected to provide liquidity if needed. She noted that both Finance Minister Guido Mantega and Central Bank President Henrique Meirelles had confirmed their support.

¶8. (SBU) Despite the turbulence, Itau Bank has not altered its base case scenario. Oreng told Econoff that economic growth is still on pace to reach five percent this year, and that only in 2009 would Brazil see possible ramifications of a global slowdown. He said that under the worst case scenario, Itau forecasts that exports

would decline and growth could fall to approximately three percent. Oreng stated that because only 15 percent of exports go to the U.S., a U.S. slowdown on its own would not disrupt Brazil's trade balance. He noted, however, that a global slowdown would be more of a risk for the Brazilian currency if demand for commodities continued to decline. Finally, he pointed to the domestic economy as Brazil's engine of growth and told Econoff that he believes the domestic economy should continue to drive economic growth.

Comment

¶9. (SBU) While it is clear that markets are spooked and still looking for the floor of the financial crisis, the outlook in Brazil remains optimistic if guarded. The major concern is centered on the continued access to international credit which, if it becomes overly restricted, will have a negative impact on Brazil's growth rate at least in 2009. A world economic slowdown that reduces international demand for Brazilian commodities would have a negative impact on Brazil's trade balance, but given that Brazilian growth is driven by the domestic sector, the overall impact should be manageable. The Brazilian financial community is certainly concerned, but there is no sense of panic. End Comment.

¶10. (U) This cable was coordinated/cleared by Embassy Brasilia and by the US Treasury Financial Attache in Sao Paulo.

WHITE